

Law of easy money

A 300-year-old example of quantitative easing

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Illustration by S. Kambayashi



“IF FIVE hundred millions of paper had been of such advantage, five hundred millions additional would be of still greater advantage.” So Charles Mackay, author of *Extraordinary Popular Delusions and the Madness of Crowds*, described the “quantitative easing” tactics of the French regent and his economic adviser, John Law, at the time of the Mississippi bubble in the early 18th century. The Mississippi scheme was a precursor of modern attempts to reflate the economy with unorthodox monetary policies. It is hard not to be struck by parallels with recent events.

Law was a brilliant mathematician who used his understanding of probability to help his gambling habit. Escaping from his native Scotland after killing a rival in a duel, he made friends with the Duke of Orleans, the regent of the young king Louis XV.

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The finances of the French government were in a terrible mess. Louis XIV had

hands of various agents, who were more concerned with enriching themselves than the state. Not only was the monarchy struggling to pay the interest on its debt, there was also a credit crunch in the form of a shortage of the gold and silver coins needed to fund economic activity.

Law's insight was that economic activity could be boosted by the use of paper money that was not backed by gold and silver. He was well ahead of his time.

Establishing confidence in a new monetary system was the trickiest part. Law had the benefit of working for an absolute monarchy which could decree that taxes should be paid in the form of notes issued by his new bank, Banque Générale. He also believed, having observed the success of the Dutch in exploiting the spice trade in the East Indies, that France could use paper money to develop its colonial possessions. Hence the Mississippi scheme, under which Law created the Compagnie d'Occident to exploit trade opportunities in what is now the United States. The money raised from these share issues was used to repay the government's debts; on occasion, Law's bank lent investors the money to buy shares.

Turn this into modern economic jargon and Law could be described as creating a stimulus package for French economic activity. But rather than rescuing sunset industries such as carmaking, Law was an early venture capitalist, financing the dynamic potential of the Mississippi delta.

The problem was that the delta was a mosquito-infested swamp. According to Niall Ferguson, a historian, 80% of the early colonists died from starvation or disease. Even though the company had monopolies over things like tobacco, it had little chance of generating enough income to fund the dividends Law had promised.

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So a vicious circle was created, in which a growing money supply was needed to bolster the share price of the Mississippi company and a rising share price was needed to maintain confidence in the system of paper money. You can see parallels with recent times, in which money was lent on the back of rising asset prices, and higher prices gave banks the confidence to lend more money.

When the scheme faltered Law resorted to a number of rescue packages, many of which have their echoes 300 years later. One was for the bank to guarantee to buy shares in the Mississippi company at a set price (think of the various government asset-purchase schemes today). Then the company took over the bank (a rescue along the lines of Fannie Mae and Freddie Mac). Finally there were restrictions on the amount of gold and silver that could be owned (something America tried in the 1930s).

All these rules failed and the scheme collapsed. Law was exiled and died in poverty. The French state's finances stayed weak, helping trigger the 1789 revolution. The idea of a "fiat" currency was perceived to be the essence of recklessness for another two centuries and the link between money and gold was not fully abandoned until the 1970s, when the Bretton Woods system expired.

Of course, the parallels with today are not exact. Law's system took just four years to collapse; today's fiat money regime has been running for nearly 40 years. The growth in money supply has been less excessive this time.

Technological change and the entry of China into the world economy have generated growth rates beyond the dreams of 18th-century man. But one lesson from Law's sorry tale endures: attempts to maintain asset prices above their fundamental value are eventually doomed to failure.

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